FEBRUARY 2011

Congress took a big interest in state and local retirement funds in February, with two House subcommittees holding hearings to examine public pensions, and a California lawmaker introducing legislation that would impose federal reporting requirements on the plans. Budget issues headlined the month, though, as the House of Representatives and the Senate faced a March 4 deadline to pass a spending plan or force a shutdown of non-essential government services. The Republican-controlled House passed a bill that would cut $60 billion in spending and defund implementation of health care reform, but the bill was, essentially, DOA in the Democratic Senate. With the two parties unable to reach agreement on a longer-term budget, it appeared likely in late-February that they would avert a shutdown by passing a two-week spending measure that included $4 billion in spending cuts.

ISSUES AND EVENTS

Congressional Panel Examines Public Pensions

A leading critic of public pensions made his case before Congress in February.

At a Feb. 14 hearing of a House Judiciary Committee subcommittee, Northwestern University Professor Joshua Rauh, who wrote a paper in 2010 predicting that many state pension funds could run out of money with 10 or 20 years, said that states and localities have unfunded pension liabilities of more than $3 trillion and that "urgent action is required" to head off a federal bailout of public pensions.

"The state and local pension crisis in the U.S. reflects the fact that unfunded pension liabilities are the largest loophole in balanced budget pledges," Rauh said. "When politicians have spent money without raising taxes, pensions have proven the perfect borrowing vehicle. This hidden debt will eventually force states and localities to choose among the unpalatable options of cutting services, raising taxes, attempting to reduce benefits owed to public employees, defaulting on other obligations, or seeking a federal bailout. The best hope for a soft landing for states is to focus on measures that stop the growth of unfunded liabilities, and then attempt to renegotiate the most untenable pension obligations within the allowable state legal structures. If states perceive implicit federal backing, they may lack the incentives to undertake these fundamental reforms."

Rauh criticized pension fund accounting, especially the common use of an 8 percent investment return projection, which he said, "ignores the role of risk … specifically, the fact that future taxpayers will have to make up any shortfalls if the fund's assets fail to generate the expected 8 percent return." Rauh endorsed the Public Employee Pension Transparency Act (H.R. 567) from Rep. Devin Nunes, R-Calif., which would require public pensions to file annual reports with the U.S. treasury secretary that contain details about assets, liabilities and funding status and use a prescribed methodology.

Rauh also suggested that the federal government should allow states to issue tax-subsidized bonds for pension funding "if, and only if, it agreed to specific austerity measures. Specifically, the state would have to close its defined benefit plans to new workers, fund existing defined benefit plans on an actuarially sound basis using the new borrowing facility, and enroll all new employees in a defined contribution plan plus Social Security."

Keith Brainard, research director of the National Association of State Retirement Administrators (NASRA), said at the hearing that public pensions account for only about 3 percent of all state and local spending, that from 1985 to 2009, the median public pension investment return was 9.25 percent, and that, "Assuming a rate of asset growth consistent with historic market norms, most funds will never run out of money."

"Reports that inappropriately calculate and intermingle unrelated long-term obligations with short-term budget issues can be misleading," Brainard said. "Much misinformation regarding state debt and pensions is being circulated, mostly based on dramatic and improbable conclusions, but which nonetheless creates the mistaken impression that drastic and immediate measures are needed. A closer look at the suppositions on which many of these reports are based finds the use of overly pessimistic assumptions that simply are not in line with historical practice. In certain cases, these distortions compound each other. The result is a mischaracterization of public pensions vis-à-vis state fiscal arrangements that obfuscates and misleads more than informs and enlightens."

Brainard stressed that "State and local government retirement systems do not require, nor are they seeking, any federal financial assistance," and rejected efforts to impose federal rules on state and local pensions by referring to a fact sheet distributed by NASRA and nine other public sector groups that concluded that "One-size-fits-all Federal regulation is neither needed nor warranted and would only inhibit recovery efforts already underway at the state and local levels."

The possibility of allowing states to declare bankruptcy was discussed at the hearing, but neither Rauh nor Brainard nor the two other witnesses on the panel supported it. The Republican chairs of both the Judiciary Committee and the subcommittee holding the hearing also expressed doubts about the approach while being very critical of public pensions. (A fact sheet released on Feb. 18 by NASRA and 10 other groups said that a bankruptcy option would be "treacherous because of its unintended consequences. The mere existence of a federal law allowing states to declare bankruptcy would only serve to increase interest rates, rattle investors, raise the costs of state government, create more volatility in financial markets, and erode state sovereignty under the 10th Amendment to the U.S. Constitution.")

Judge Rules Against Health Care Reform Law; Repeal Voted Down in Senate

Opponents and supporters of the health care reform law each won a battle recently.

In Florida on Jan. 31, U.S. District Judge Roger Vinson ruled in a case brought by 26 state attorneys general that, not only is the reform law's requirement that all Americans have health insurance unconstitutional, but that because of that, the entire law must be struck down.

The individual mandate, Vinson ruled, cannot be justified under Congress' power to regulate interstate commerce, and the provision is so intricately tied into other aspects of the law, that, if it is unconstitutional, the entire law must be thrown out.

"Going through the 2,700-page Act line-by-line, invalidating dozens (or hundreds) of some sections while retaining dozens (or hundreds) of others, would not only take considerable time and extensive briefing, but it would, in the end, be tantamount to rewriting a statute in an attempt to salvage it," Vinson wrote. "Courts should not even attempt to do that. It would be impossible to ascertain on a section-by-section basis if a particular statutory provision could stand (and was intended by Congress to stand) independently of the individual mandate."

Vinson, though, rejected a request by the plaintiffs that he block implementation of the law. The Obama administration on Feb. 17 asked him to clarify his ruling by asserting that, while the case is being appealed, states must continue to implement the law. (Officials in several states said recently that they will not do so.) The judge gave the states involved in the case until Feb. 24 to respond to the federal government's filing.

The administration, to no one's surprise, pledged to appeal the ruling.

"We strongly disagree with the court's ruling today and continue to believe - as other federal courts have found - that the Affordable Care Act is constitutional," a Department of Justice spokeswoman said. "There is clear and well-established legal precedent that Congress acted within its constitutional authority in passing this law, and we are confident that we will ultimately prevail on appeal."

The next judicial level is the U.S. Circuit Court of Appeals, but the U.S. Supreme Court is sure, eventually, to have the final say. Two federal judges have now ruled against the individual mandate, and two have ruled that it is permissible under the Constitution. Vinson is the only judge at this point to have ruled against the entire law.

In the Senate, meanwhile, Republicans on Feb. 2 forced a vote on repealing the reform law, but, as expected, Democrats held off the challenge.

The GOP-controlled House of Representatives voted for repeal in January, but Senate Majority Leader Harry Reid, D-Nev., said he would not bring the House-passed bill before the Senate. Republicans worked around this by tacking the legislation on to an unrelated aviation bill, but the repeal effort was defeated 51-47, with all Democrats present opposing it and all Republicans present supporting it.

Although it was always clear that Republicans would fail in the effort, some GOP lawmakers said the vote was more than symbolic.

"There's a narrative I've seen and read out there that this was somehow a futile act because Republicans didn't have the votes to repeal Obamacare," Sen. John Cornyn, R-Texas, said. "But I have to tell you, these are the first steps in a long road that will culminate in 2012 whereby we will expose the flaws and the weaknesses in this legislation."

The parties did agree on Feb. 2, in an 81-17 vote, to repeal a provision of the bill that requires businesses to file a 1099 tax form when they pay a vendor more than $600 in a year. The measure has been widely criticized for imposing an administrative burden on small businesses. The House has passed a similar measure, and President Obama has said that he will sign legislation that undoes the mandate.

The vote came a day after two Republican senators introduced legislation that would allow states to opt out of certain major provisions of the reform law.

The "State Health Care Choice Act" (S. 244) from Sen. John Barrasso, R-Wyo., and Sen. Lindsay Graham, R-S.C., would permit states to disregard the individual mandate as well as the reform law's requirements concerning the provision of insurance by large companies and its mandates regarding state expansion of Medicaid programs. The objective of the legislation is much broader, however.

"If you take half the states out of the individual mandate, this bill falls," Graham said. "Quite frankly, that's the goal."

GOP Spending Bill Would Defund Health Care Reform, Cut SEC, CFTC Budgets

The House of Representatives on Feb. 19 voted to prohibit funding for health care reform implementation for the rest of the fiscal year.

The previous session of Congress did not pass a budget for fiscal 2011, just a temporary spending bill that expires on March 4. Lawmakers must now enact legislation that funds the government from that point until the end of the fiscal year on Sept. 30.

The $1.2-trillion spending bill passed by the Republican-controlled House by a 235-189 vote would cut spending by $60 billion, with a small part of that savings coming from defunding health care reform implementation. The measure was not originally a part of the bill, but was added in the form of an amendment from Rep. Denny Rehberg, R-Mont., that was approved by a vote of 239-187 on Friday.

"We wanted to create jobs," Rehberg said to Democrats on the House floor. "You wasted time on the health care reform."

Democrats sharply criticized the vote.

"Instead of searching for common ground, this amendment intensifies warfare," Rep. Sander Levin, D-Mich., said. "Republicans have become a wrecking crew."

With Democrats holding a majority of seats in the Senate, the bill stood almost no chance of passing that chamber – Senate Majority Leader Harry Reid, D-Nev., called the spending cuts "draconian" – and even if it did, President Obama would certainly veto it. This set up a budget impasse that, if not resolved by March 4 – even if only by another short-term spending measure – would force the federal government to shut down non-essential services.

It appeared, though, that both sides were willing to pass a two-week spending measure that included $4 billion in cuts when they returned to Washington from the Presidents Day recess. That would give them until March 18 to enact additional spending legislation, whether another short-term measure or one that would fund government activities for the rest of the fiscal year, which ends on Sept. 30.

In addition to the health care provisions, the House bill would also prohibit the Environmental Protection Agency from enforcing new rules on greenhouse gas emissions and would eliminate funding for the Intergovernmental Panel on Climate Change and presidential advisors on climate change. Also, it would limit funding for agencies charged with enforcing financial regulations. The bill would:

- Cap funding for the Consumer Financial Protection Bureau (CFPB) – an agency created by last year's financial regulations reform bill – at $80 million this year.
- Cut the Securities and Exchange Commission's (SEC) $1.1 billion budget by $25 million.
- Reduce the Commodity Futures Trading Commission's (CFTC) $169 million budget by almost $57 million.

A coalition of more than 250 organizations wrote in a letter to lawmakers on Feb.15 that the proposed cuts to the SEC and CFTC budgets would "starve the two agencies of the basic resources they need to police the safety and integrity of our financial markets, and increase the danger of another financial crisis."

"The proposed $56 million cut to the CFTC's $168.8 million budget is particularly disturbing," the letter stated. "It is shocking that Congress would even consider a proposal that would have the effect of eviscerating the agency with central responsibility for assuring transparency and stability in the derivatives market, on which the health of the overall economy depends. It is difficult not to see these cuts as a back door effort to block new requirements for transparency and accountability, and not budget measures at all."

The letter was part of an effort led by the Council of Institutional Investors, the Consumer Federation of America and Shareowners.org to mobilize people to oppose the cuts.

Rep. Barney Frank, D-Mass., the lead writer of the reform bill in the House last year, said that Republicans are "using the bill to try to re-deregulate: They're going after the SEC, the CFTC and the CFPB and it is an effort to undo independent consumer protection."

Repealing Health Care Reform Would Increase Deficits, Uninsured: CBO

Repealing the health care reform law would increase federal budget deficits by more than $200 billion over the next decade and result in 33 million people not having health insurance in 2021 who otherwise would have, the Congressional Budget Office (CBO) concluded in its latest report on efforts to undo reform.

The Republican-controlled House of Representatives in January passed legislation to repeal the reform law, but the Senate voted down the measure. Were repeal efforts to succeed, according to the CBO, federal spending would be cut by $604 billion between 2012 and 2021, and federal revenues would be reduced by $813 billion, resulting in an increase in deficits of $210 billion.

Meanwhile, the percentage of non-elderly residents with health insurance in 2021, assuming repeal, would be 82 percent, 13 points lower – a difference of 33 million people – than the 95 percent that is projected if the reform law stays intact.

Treasury Establishes Consumer Bureau Website

The U.S. Treasury Department has created a website on which it is seeking public input on the creation of the Consumer Financial Protection Bureau.

The bureau, which was included in last year's financial regulations reform law, is to provide oversight of mortgages, credit cards, student loans and other consumer financial products. The site www.consumerfinance.gov includes a suggestion area, a blog, information about the bureau and Elizabeth Warren, the special assistant to the president who is leading its creation, and resources about consumer products and services. Although the site warns that, "We can't help yet because the Consumer Response Center is still being established," it includes an online form that directs visitors to other agencies that can help with their questions or complaints.

"We have the opportunity to create a brand new consumer agency from the ground up," Warren said in a video posted on the site. "We want to make sure that the American people are with us all the way while we build it."

TARP Bank Programs Nearing Profitability

The United States is close to turning a profit on the portion of TARP funds that provides financial support to banks.

The Troubled Asset Relief Program (TARP) has disbursed $245 billion to banks and has received $243 billion in repayments and other income. The TARP bank programs are expected eventually to provide a $20 billion profit.

"As the economy heals, we're continuing to see private capital step up and replace public support in the financial sector, which has dramatically lowered the cost of TARP for taxpayers," Acting Assistant Secretary for Financial Stability Tim Massad said.

All told, TARP - which has also provided funds to the auto industry, AIG, credit markets and foreclosure prevention programs - has disbursed $410 billion and has received $238 billion in repayments and $36 billion in other income."

RELATED NATIONAL AND INDUSTRY NEWS

Financial Crisis Panel a Partisan Creation, Commission Vice Chair Tells Congress

The commission created by Congress to investigate the nation's recent financial crisis was formed "for political purposes, with a partisan structure and a partisan 22-point agenda," the lead Republican on the panel told members of Congress in February.

The Financial Crisis Inquiry Commission spent about a year holding hearings to try to determine what led to the bursting of the housing bubble, the collapse of major financial firms, an economic recession and other fiscal troubles. The final report, which was released in January, was endorsed by only the six Democrats on the 10-member panel. Three GOP members of the commission drafted a dissenting report and the fourth Republican commissioner released his own report.

Commission Vice Chairman Bill Thomas, a former Republican congressman from Bakersfield, Calif., noted at the Feb. 16 hearing of the House Financial Services Committee that, with six Democrats and four Republicans on the panel, "the math was simple."

"When inordinate hours of staff time are being used to find 'gotcha' documents to support provocative headlines rather than to produce material relevant to commissioner deliberations," Thomas said, "when the proceedings of private commission meetings are inaccurately leaked again and again in an attempt to embarrass the minority and create artificial hype for a commercial book, when the minority is forced to vote on potentially illegal motions presented to them just one day prior, when the final findings and conclusions of the majority are first presented to the minority four days before the final vote, and when minority views are then excluded by a 6-4 vote from the report and suppressed in the commercial book, in the event presenting the report, and on the commission's website, it becomes abundantly clear that consensus is not a primary goal."

Commission Chairman Phil Angelides, the former California state controller, defended the panel's work, saying, "The facts have not been challenged. Everyone can draw their own conclusions."

"As to the lack of consensus, let me first say all ten commissioners were afforded the opportunity to provide extensive input as we undertook our work," Angelides said. "While commissioners were not unanimous on all issues or on the emphasis we placed on key causes of the crisis, there were, in fact, many areas of agreement. Importantly, setting aside the conclusions and dissents, this report contains a valuable and accurate historical account of the events leading up to the crisis and the crisis itself."

The commission's report is selling well, reaching No. 10 on the *New York Times* nonfiction paperback best-seller list in mid-February.

CALIFORNIA CONGRESSIONAL DELEGATION NEWS

Public Pension Reporting Bill Reintroduced; House Panel Examines State Pensions, Debts

A California congressman and a North Carolina senator on Feb. 9 introduced legislation that would impose federal reporting requirements on state and local pension plans.

The Public Employee Pension Transparency Act (H.R. 567) from Rep. Devin Nunes, R-Calif., would require public pensions to file annual reports with the U.S. treasury secretary that contain details about their assets, liabilities and funding status using a prescribed methodology and would threaten non-compliant states and localities with a denial of federal tax benefits for their bonds. The bill also would prohibit federal bailouts of state and local pension plans. Nunes introduced the bill in December, but it died when the last session of Congress adjourned. Unlike the December proposal, Nunes' current legislation has a companion bill in the Senate, sponsored by Sen. Richard Burr, R-N.C.

"Public employee pensions represent trillions of debt carried by the American taxpayer," Nunes said. "Unfortunately, this debt is masked by accounting practices that would never be tolerated in the private sector. It's time to open up the books. Once we enact this bill, retirees, government workers, policy makers, and, most importantly, the people who are paying the bills can make up their own minds about the soundness of public pensions."

The bill is strongly opposed by the public pension community, which generally regards it as part of an organized effort to reduce spending on public pensions and push for conversions to defined contribution plans. Several groups involved in public pensions, including the National Association of State Retirement Administrators (NASRA) and the National Council on Teacher Retirement, have called the proposal "inappropriate" and "unwarranted" and said in December that it "represents a fundamental lack of understanding regarding the strong accounting rules and strict legal constraints already in place that require open and transparent governmental financial reporting and processes." The groups have also stressed that states and localities are not seeking federal bailouts.

"Their new legislation is no different," NCTR Executive Director Jim Mosman said after the latest bill was introduced. "It would recklessly create turmoil in the municipal bond markets and scare bondholders, taxpayers and retirees by erroneously claiming our members' pension trusts will soon be exhausted. That is simply not the case."

Nunes legislation was referenced by Rep. Patrick McHenry, R-N.C., the chairman of the TARP, Financial Services and Bailouts of Public and Private Programs Subcommittee of the House Oversight and Government Reform Committee during that panel's Feb. 9 hearing on state and municipal debt. Noting that he had worked with Nunes on the bill, McHenry said that the proposal would "require greater transparency at the point of most urgent [budgetary] concern, the pension problem."

"States and municipal governments, who are preparing for aggregate budget shortfalls totaling roughly $125 billion this year, are struggling under a trillion-dollar burden of unfunded pension liabilities, plummeting tax revenues and an unforgiving bond market," McHenry said. "We must understand the magnitude of the problem to avoid the reactionary, ad hoc decision-making that fueled federal action in the 2008 financial crisis. … The perfect storm is brewing. Already, state and municipal governments are coming to Washington, hat-in-hand, expecting a federal bailout like everyone else. But the era of the bailout is over."

Ranking Democrat Mike Quigley of Illinois, however, rejected McHenry's assertions, saying that most state pension plans do not have serious underfunding issues, and that those that do can attribute them to specific causes, such as a failure to make regular pension fund payments.

Iris Lav, senior advisor for the Center for Budget and Policy Priorities echoed Quigley's comments in playing down the pension problems, saying that states and localities do not face an immediate crisis since they "have the next thirty years in which to remedy any pension shortfalls." Lav also said that, while critics often claim that aggregate public pension shortfalls total $3 trillion, they arrive at that figure using a "riskless" rate of investment return that is based on U.S. Treasury bonds. Using the "historical return on plans' assets," the long-term shortfall drops to $700 billion.

"States and localities do not need to increase contributions immediately," Lav said, "and generally should not do so while the economy is still weak and they are struggling to provide basic services."

Eileen Norcross, senior research fellow at the Mercatus Center at George Mason University, interpreted things very differently, arguing that "many state and local governments face a very significant obligation beginning in the near term. Meeting this obligation requires that state and local governments institute pension reform now." She objected to using a rate of return higher than the "riskless" rate to calculate liabilities because, she said, this gives plan managers "an incentive to take on more investment risk to realize higher expected returns on plan assets."

"In fact, as a result of the market downturn, some plans are taking on even more risk to make up for losses, exposing funds to greater losses when the stock market performs poorly," Norcross said. "California's state pension plan, CalPERS, lost $500 million in the financial collapse of the Stuyvesant Town-Peter Cooper Village real estate venture in 2009. In spite of this, to avoid raising the contribution rate for state agencies, CalPERS has expanded its equities holdings from 49.1 percent of 53.1 percent, exposing the portfolio to more volatility in the short-run."

Norcross recommended that states and localities replace their defined benefit pension plan with a defined contribution plan that "allows younger workers more career flexibility, shifts the risk of plan underfunding away from taxpayers, and, I would argue most importantly, ends the political and fiscal manipulation of worker benefits which has turned what was intended to be a safe investment for public sector workers into a gamble for both public employees and taxpayers."

Professor David Skeel of the University of Pennsylvania Law School, was the only witness to endorse giving states the ability to declare bankruptcy, a proposal that has lately become popular in some conservative circles. This, he said, would give financially troubled states "a solution of last resort that does not depend on using a major federal bailout as a backstop."

"With pensions, many states now make it nearly impossible to restructure existing pension obligations, no matter how generous, and it is very difficult to restructure even future – that is, not yet earned – obligations to existing employees," Skeel said. "Many of the most important protections for pensions would be fully honored in bankruptcy, and rightly so. … Even in bankruptcy, it is highly unlikely that any state would severely retrench on its pension promises, even if this were legally permissible. But even a relatively modest restructuring of the state's pension obligations could make the long-term prognosis for its pensions far better."

Nicole Gelinas, Searle Freedom Trust fellow at the Manhattan Institute, however, rejected the bankruptcy option. Allowing states to declare bankruptcy, she said, would do little to address their budget problems because of the nature of state finances, which can include state constitutional provisions regarding certain spending.

"State laws that ensure burdensome pension benefits and union-contract outcomes may be bad practice, but no one has argued that they violate the U.S. Constitution," Gelinas said. "Therefore, a federal judge cannot overturn them – only state legislatures, governors and voters can do that. With no ability to overturn bad state statutes and constitutional provisions against the will of governors and state lawmakers, a federal bankruptcy judge would have little power."

Gelinas also downplayed the role of pension obligations in states' financial crises, noting that pension costs account for only 3-3.5 percent of total state spending. Still, however, she recommended that states convert to defined contribution accounts.